A Communications Review for the Digital Age

BSG response to the Secretary of State's open letter

Ensuring a strong and competitive market for communications services is of fundamental importance for consumers and businesses and should be at the cornerstone of the UK's strategy for growth.

Introduction

In advance of the recent e-G8 summit in Paris McKinsey & Company was asked to prepare a report on the impact of the internet on growth, jobs and prosperity[i]. McKinsey looked at 13 countries that collectively account for more than 70 per cent of global GDP and found that on average the internet accounts for 3.4 percent of GDP in the countries studied and that the internet's total contribution to global GDP was bigger than the GDP of Spain or Canada and is growing faster than the GDP of Brazil. However, in only two countries did the internet account for more than 5 percent of GDP, these countries were Sweden and the United Kingdom.

Over the last 15 years the internet was assessed to have contributed 11 percent to the UK's growth rate which increased to an impressive 23 percent over the last five years. The UK's success relative to other similar mature economies in the G8 was explained by the authors by its strong and competitive telecoms market, high levels of consumer adoption and use and, in particular, the transformative impact the internet has had on its SMEs.

Whilst the UK communications market does not always top the international rankings, in particular when it comes to headline broadband speeds, the UK does perform consistently well in studies that look at outcomes and the productive use and benefit derived from communications services. This is significant as it suggests that the starting point for any review of the Communications Act must be the relative success of the UK market in delivering compelling services at compelling price points that have driven a high level of take-up and use by consumers, large businesses and SMEs. It is the adoption and use of new communications services and applications that ultimately drives increases in productivity and growth.

The Communications Act review process should therefore be asking: what has enabled this story of relative success; whether the factors that have driven this success in the last decade will be the same as the success factors in the decade ahead; and what changes may be required to ensure and build upon that success?

The UK's communications sector has been a force for growth over the last decade – more statistics

- The McKinsey e-G8 report reveals that the UK is a world leader in the way it exploits the internet and that the internet accounts for 5.4% of UK GDP – ahead of South Korea, Japan, the United States and Germany
- The UK is ranked 6th in the Boston Consulting Group's e-Intensity Index which measures internet activity (depth and reach of the internet in commerce and society) across OECD countries – ahead of Germany, the United States and France[ii]

- The Boston Consulting Group has estimated that if the internet was a separate sector it would be the UK's fifth largest after real estate and business services, manufacturing, wholesale and retail and financial services.
- The UK's communications market generates a large consumer surplus, as services such as e-mail, social networking, search and video streaming continue to provide higher levels of value add to internet users. Indeed McKinsey estimate that the UK has the highest net internet consumer surplus in the G8 (€20 per month per user).
- The UK is one of the strongest and most consistent performers on the NSN Connectivity Scorecard[iii] and was ranked 6th amongst innovation driven economies in 2011, with particular strengths in business take-up and use and consumer adoption.

The statistics above demonstrate that in terms of outcomes the UK communications market has functioned well over the last decade. However the condition for success in the decade ahead will not necessarily be the same as the decade that has just passed and the need to deploy new next generation fixed and wireless networks in particular will present challenges, both in ensuring timely and sufficient investment and effective ongoing competition in service provision.

A strong communications market is fundamental for growth across the whole economy
Companies across the whole economy depend upon the internet – not just the creative industries. In particular the really significant productivity benefits of ICT start to come through when SMEs, in all sectors, start to use the internet.

According to McKinsey:

- 75 per cent of the economic impact of the internet arises from traditional companies that don't define themselves as internet players.
- According to McKinsey, SMEs that are intensive users of the internet grow twice as quickly as non internet intensive SMEs and generate double the amount of exports. They also generate twice the number of jobs

Whilst the internet and IP based digital technologies are clearly of fundamental importance to the creative industries (a point we will return to later) it is important that the internet and the relevance of the communications sector is not seen simply through the narrow lens of the creative industries.

The shift in responsibilities for the communications sector from BIS to DCMS does raise some genuine concerns in this regard, as responsibility for the sector has passed from a large department responsible for UK business as a whole, to a smaller department responsible for one vertical sector – the creative industries. This suggests that there may be a case for renaming the department as the Department for Communications, Culture, Media and Sport (DCCMS). This would be more than just a gesture but mark a clear recognition that the responsibilities of the department have been significantly expanded.

The 2003 Communications Act had a significant and on the whole very positive impact on the communications market in the UK. Much of that success can be put down to the effective pre-legislative consultation and well informed cross party debate that shaped the Act. Ensuring a similarly well informed debate through the course of this review will be essential for ensuring a good outcome from the process.

Questions

Q1. What could a healthier communications market look like? How can the right balance be achieved between investment, competition and services in a changing technological environment?

As described above the UK has benefited from a strong and vibrant communications market over the last decade. In global terms there is no evidence that the UK is failing to compete in leveraging the growth potential of the internet. However, the pace of development in the communications sector globally is staggeringly fast and it cannot be assumed that the UK will automatically maintain its leadership position.

Competition has been key to the UK's success over the last decade as it has driven investment, innovation, choice and low prices across the communications sector. Indeed there may well be a correlation between the level of competition and extent of the GDP benefit gained when the UK is benchmarked against other European economies. And this is something that may be worthy of further study through the course of the review.

However, looking forward it is necessary to ask whether the factors of success in the last decade will carry over to the next. In particular it has been questioned whether a decade of strong competition might have exhausted the market's ability to invest, particularly at the levels that will be required to deliver next generation fixed and wireless networks. This is an argument that was made in the US in the middle of the last decade, leading to the withdrawal of LLU obligations and is being made by several telecoms operators currently across Europe[iv].

Given the evidence of investment now starting to take place in next generation infrastructure in the UK it would seem premature to jump to this conclusion, yet it is a central question and one that the Communications Act review process should have a clear and well informed view on.

The last 10 years has also seen continual pressure on prices. However, it is an open question whether the market can sustain similar price reductions in the decade ahead, when large sustained capital investment will be required to build out new infrastructure. Again, this is an issue that the review will need to develop a clear and well informed view.

The other fundamental question in relation to competition is the impact of convergence. Over the last ten years we have moved from a theoretical and conceptual discussion about convergence to the point where we are seeing convergence in practice (of devices, services and markets) on a daily basis. This presents a particular challenge for regulation which is based on a set of distinct *ex ante* broadcast, spectrum and telecoms powers and a set of market definitions that are essentially horizontal, when future enduring competition bottlenecks may be more likely to emerge from vertical integration, where Ofcom has to rely upon its *ex-post* competition powers. To be effective the *ex-ante* framework needs to be seamlessly interleaved with the *ex-post* competition framework.

Vibrant competition requires a strong independent regulator

The converging communications sector is fast moving and highly complex with multiple interdependencies both within and across markets. It is driven by rapidly evolving digital technology yet it is also built upon a complex legacy of sector specific *ex ante* regulation pertaining to broadcast, spectrum and telecoms that has evolved and been amended over a long period of time. All of this makes it an exceptionally complex sector to regulate, yet effective regulation is fundamental to ensuring a well functioning competitive market.

A confident, well informed, independent regulator has a vital role to play in implementing the regulatory framework in an appropriate, proportionate and timely manner. To be effective the regulator requires a high level of technical, commercial and regulatory skills and capabilities and needs to be able to use both its formal and soft powers with considerable discretion to steer the market towards good outcomes.

Ofcom has been criticised in recent years for becoming too powerful and for leading the policy development process. To some extent this resulted from an asymmetry that emerged in its early years between its capabilities and the capabilities of its sponsor departments. Whilst this trend did perhaps need to be checked, it is important that any correction does not go too far. A weak communications regulator would not be a good outcome for the sector or the economy as a whole.

The regulator must also be the custodian of the big picture, able to understand a complex and converging set of markets and act quickly and resolutely when necessary to address bottlenecks. This means it must be well informed, close to the markets it regulates and adequately resourced.

If a rebalancing between the regulator, the executive and the legislature is deemed necessary it should probably come about from a strengthening of ministerial, departmental and parliamentary expertise rather than a weakening Ofcom's capabilities (although Ministerial interest in the arcane complexities of spectrum management has been the exception rather than the rule over the last ten years.).

Long-term investment requires a stable and predictable regulatory regime
Companies making large scale investments with long-term pay back will necessarily look to the regulator and government for regulatory stability and predictability.

Ofcom's principal duties remain valid
Ofcom's principal duties are to further the interests of citizens in relation to communications matters; and to further the interests of consumers in relevant markets, where appropriate by promoting competition. These duties remain appropriate and valid and do not need to be amended.

Balancing short and long-term interests
The distinction between the consumer and the citizen is very useful as it captures the need to balance the immediate interests of the individual consumer and the longer-term collective interests of the citizen. It is important that the distinction between the citizen interest and the consumer interest is not lost. Media and political pressure will always tend to be more focused on shorter-term consumer issues and it is important that the regulator does not see its role simply to be the consumer champion. Consumers can't express preferences for future public goods or so-called experience goods and the interests of market players will not always be aligned with wider citizen interests, therefore Ofcom has a vital role to play in understanding, articulating and supporting long-term citizen interests.

Ofcom's specific duties remain valid and don't need to be amended

Ofcom has the following duties:

1. Ensuring the optimal use of the electro-magnetic spectrum
2. Ensuring that a wide range of electronic communications services – including high speed data services – is available throughout the UK
3. Ensuring a wide range of TV and radio services of high quality and wide appeal
4. Maintaining plurality in the provision of broadcasting
5. Applying adequate protection for audiences against offensive or harmful material
6. Applying adequate protection for audiences against unfairness or the infringement of privacy

The current Communications Act is often criticised for making no explicit reference to either the internet or the World Wide Web. However, both are implicit in the term 'electronic communications service' and it is not apparent Ofcom's remit has been limited by a lack of reference to either in the Act. It is therefore not obvious that the list of duties needs to be amended.

The one area where the UK has been less successful is in ensuring optimal use of the electro-magnetic spectrum. Other countries have succeeded in releasing new spectrum more quickly into the market. The reasons for this are complex and solutions are not obvious, however, this is an issue where the review should have a clear and well informed position.

Q2. What action can be taken to facilitate greater innovation and growth across the wider competition regime, and how can deregulation help achieve this?

As markets become more competitive it should be possible to reduce ex-ante regulation on players without significant market power (SMP) and this has happened over recent years as markets have become more competitive.

Q3. Is regulatory convergence across different platforms desirable and, if so, what are the potential issues to implementation?

We are seeing continued convergence of devices, platforms, services and markets and it is essential that the regulatory framework remains relevant to the realities of how the market operates in practice. On the whole this convergence is leading to an increase in competition as new substitutes emerge for more established products and services and as a result should lead to a reduction *ex-ante* regulation. Ensuring that the market definitions used by the regulator keep pace with actual market developments will be a key challenge to successful regulation in a converging market place.

However, the regulator must also remain vigilant to the risk of new unforeseen bottlenecks emerging as a result of convergence that could limit competition. For example a trend towards more vertical integration could start to reduce competitive pressures in the market place. In theory Ofcom's *ex-post* competition powers should be sufficient to deal such circumstances, however it will be important to consider whether the combination of Ofcom's *ex-ante* and *ex-post* competition powers will be sufficient to ensure that a more converged communications market remains open and competitive. Again this is an issue that the Communications Act review process will need to take a clear and well informed view upon.

Q4. What barriers can be removed to facilitate greater exports and inward investment and make the UK more globally competitive in digital communications?

A strong and competitive domestic market with high levels of consumer and business adoption is a necessary pre-requisite for driving exports and inward investment. However, strong competition alone will not necessarily be sufficient to drive these outcomes. The McKinsey e-G8 report argues that countries with a high internet contribution to GDP correlate to those with a strong internet supply ecosystem. Achieving GDP growth through the communications sector will therefore depend upon achieving real strength on both the supply side and the demand side. However, supply side concerns should be a matter of policy and policy choices rather than an objective of market regulation. However there are some members of the BSG that believe that Ofcom's duties should be amended to include a requirement to consider and promote as appropriate the requirements of UK industry.

Over the last decade levels of R&D investment in communications products and services in the UK has declined and this is one factor that the UK government could and should do more to reverse. Securing existing R&D investment and attracting new R&D foreign direct should be a priority. Around the world countries and regions are fighting harder than ever to attract R&D investment through a combination of financial and other incentives, because they believe that such investment delivers significant positive spill over effects. Government should review whether it is doing enough in this regard.

Q5. What further market and regulatory developments would lead to widespread take-up of superfast broadband? What regulatory action would government need to take to make superfast broadband more readily available in a) urban areas; and, b) rural areas?

The BSG believes strongly in the fundamental importance of broadband for the UK economy and the need to ensure timely and widespread availability of next generation broadband across the UK. However, enthusiasm about the long term potential of next generation broadband needs to be matched with realistic expectations about the likely pace of take-up. Experience from other markets around the world suggests that where good current generation of broadband services already exist, super fast broadband adoption takes time.

Competition will be the biggest driver of take-up as market players compete to promote and advertise their services and drive their own market share. In a competitive market it is the responsibility of the market players to find innovative and effective means to drive take-up and there are already some interesting examples of broadband providers in different markets taking innovative approaches to increasing their market share – including City Broadband in Hong Kong, which gave away free air conditioning units and other consumer goods, to drive take-up of its fibre services.

Government should focus its activity around driving the hard to reach market segments, such as the elderly or socially excluded. Race Online 2012 already plays an effective role in this regard and there may be an argument for increasing its funding.

The availability of next generation broadband in urban areas will largely be driven by competition, although there may be some isolated exceptions that may need additional support. Again ensuring effective competition will be key. The deployment of new mobile LTE services in urban areas will provide an important additional competitive stimulus in the market and will encourage fixed line operators to ensure that their services are not susceptible to mobile substitution.

The BSG has long argued next generation broadband deployment in rural areas would require additional public funding and supports the overall BDUK approach to managing this subsidy. However, BSG remains concerned that the relatively small scale of the projects being funded by BDUK could be problematic and is particularly concerned about the need to ensure that big national retail providers with the retail expertise, scale and capacity to drive take-up have cost effective access to small local networks. Where small independent networks have been deployed either in the UK or internationally, they have struggled to attract competitive retail service providers to their networks as they are generally too small to justify the systems investment required by a major service provider to integrate a new network supplier. As a result they have often had to resort to self provisioning retail services with a consequent lack of choice and competition at the retail level for end customers. This can hamper the ability of networks to attract customers and insufficient take up can quickly challenge the operational viability of a business. The BSG therefore believes that overcoming this challenge will be a critical factor in the success of the final third initiative.

Ultimately, it will be the availability of a diverse range of compelling services and applications, delivered at quality of service that meets or exceeds consumer expectations, which will drive take-up of next generation broadband. Innovation in services and business models will be as important as investment in the underlying infrastructure.

Q6. What are the competing demands for spectrum, how is the market changing and how can a regulatory framework best accommodate any rapidly changing demands on spectrum and market development?

Q7. How should spectrum be managed to deliver our growth objectives whilst also meeting our policy objectives of furthering the interests of citizens and consumers in relation to communications matters?

Q8. How should the UK engage on an EU/International level in relation to spectrum?

Spectrum is an essential tool for achieving innovation and competition in the communications market. However, there are many vested commercial interests and competing demands for spectrum which makes the management of spectrum an extremely complex and challenging issue. Compared to other countries the UK has been late in releasing additional spectrum to the market which suggests that the UK's approach to spectrum allocation has not yet been as successful as was hoped. Significant effort should be dedicated to understanding why this has been the case and considering whether the present system could be improved. The BSG does not underestimate the difficulty of this task.

Key to success is the need t ensure UK spectrum policy is harmonised with other large markets to ensure that the UK can benefit from scale economies. An effective balance will also need to be found between achieving value from spectrum auctions and delivering economic benefit by ensuring that roll out occurs.

Q9. Is the current mix of regulation, competition and Government intervention right to stimulate investment in communications networks?

Balancing the needs of competition and investment, in order to deliver both, is a constant challenge requiring complex well informed trade-offs to be made. Overall the UK market has performed well and investment is now underway in new next generation communications networks in both urban and rural areas, although it will take several years for this investment to be completed. It is unclear whether the amount of funding made available for next generation in the final third will be sufficient. To some extent this will depend upon how efficiently this money is spent and to what effect. If more future proofed solutions are preferred, additional public funding may be required to complete rural deployment.

Q10. Are there disproportionate regulatory barriers to investment in content? If so, what are they and how can increased investment in UK content production be encouraged?

Digital convergence is having an increasingly significant impact on investment decisions on all forms of content and all content platforms, be they games, film, television, or radio. Digital convergence is proving highly disruptive to traditional business models requiring established content players to rethink how they can continue to invest in the content market. This is a global phenomenon and not one that can or will be reversed.

With this in mind there is a real need to ensure that unnecessary or outdated national regulation does not present an additional barrier in already challenging global market place. However there are some areas where content regulation remains legitimate:

- Public service broadcasting – where spectrum rights and/or public funding are balanced with PSB obligations
- Consumer protection related to harm or offence
- Protection of Intellectual property
- Privacy and data protection
- Consumer protection

Q11. Should the core focus of public service broadcasting be on original UK content?

The BSG does not hold a particular view on this issue.

Q12. What barriers are there to innovation in new digital media sectors, including video games, telemedicine, local television and education?

There are three challenges to ensuring innovation, investment and growth in new digital media services:

- Protection of intellectual property
  The concept of intellectual property remains of fundamental importance in a modern digital economy and must be protected in a fair and appropriate way. The Hargreaves IP review set out some useful recommendations in this regard and has received broad cross-sectoral support. However, much more of the detail will need to be worked through before we can be confident that the challenge of IP protection in a digital age has been successfully addressed in a way that meets the legitimate needs of commercial stakeholders and consumers.

- Ensuring Trust
  Ensuring effective data protection, information security and privacy will be key to maintaining consumer trust in new digital media services, particularly where the production and use of consumer data is likely to be fundamental to new commercial business models.

- Payment systems and payment regulation
  Enabling a competitive market for new low cost payment systems will be essential for enabling micro –payment systems which will also be critical for new business models to emerge.

Addressing these three points will be essential to ensure that we have a strong base of active, confident and informed users and consumers.

Q13. Where has self- and co-regulation worked successfully and what can be learnt from specific approaches? Where specific approaches haven't worked, how can the framework of content regulation be made sufficiently coherent and not create barriers to growth, but at the same time protect citizens and enable consumer confidence?

The Broadband Stakeholder Group (BSG) has been directly involved in a number of different self- and co-regulatory initiatives.

- BSG facilitated Good Practice Principles on Audiovisual Content Information, February 2008
- The establishment of ATVOD – Independent Co-Regulator for the editorial content of UK video on demand services , (Designated by Ofcom in March 2010)
- Voluntary industry code of practice on traffic management transparency for broadband services, March 2011

On the basis of this experience we have a number of observations:

1. **In theory the case for self-regulation in the internet/web space is compelling.** The pace of change and the global nature of the internet/web make effective statutory regulation difficult. Statutory regulation takes time and therefore struggles to keep pace with the speed of innovation and change, and the potential for web services to relocate between regulatory jurisdictions means that companies can avoid national regulations if they want to. In theory, self regulation, driven by companies and organisations at the coal face, informed by a real understanding of the market, can be both better framed and more flexible resulting in better outcomes, both in terms of the public good (the desired outcome that motivated the need for regulation in the first place) and the health of the sector. But that doesn't mean that self-regulation is always the best option. Self-regulation is much harder to achieve than is often assumed and is not always the cheapest or most cost-effective option for the market participants. Back-stop regulatory alternatives and/or powers may also need to be clearly articulated to discourage companies from flouting any self-regulatory rules.

2. **The potential for success depends upon the circumstances.** Self-regulation works best where there is a clear coalition of the willing; where commercial incentives are aligned and where the number of players is quite limited. The underlying commercial context is also significant. Where there is a strong business model supporting the services in question and a viable cost model for supporting the self-regulatory regime, it is easier to execute. However when regulatory concerns develop around new and commercially untested services, and where there is a long tail of commercial players with very different interest developing consensus, identifying and engaging with the relevant parties and securing resources can be difficult.

3. **Resourcing is significant challenge.** Self-regulation takes time and resource to set up and monitor, and agreeing how self regulation is resourced can be a real challenge. It often requires a third party (such as the BSG) to facilitate the work. But ongoing costs associated with the operation and verification need to be sourced. Furthermore, as value chains evolve and expand, the pool of "industry players" expands both in sectoral and geographical terms which can make the alignment of incentives more challenging. There is a further tipping point when a self-regulatory scheme evolves from a "coalition of the willing" which has the resource, will and incentive to engage, to trying to capture the "long tail" of relevant companies and organisations that may, for a variety of reasons, be more difficult to co-opt.

4. **There is a need to demonstrate effectiveness and establish credibility.** Self-regulation is often subject to intense scrutiny and can easily be characterised as weak and self serving. That means there is increasing pressure on industry to demonstrate effectiveness of self-regulatory codes and increasing third-party pressure put on governments and regulators to ensure this. However reviews can be difficult to scope out and also have a cost and resource

impact. It is worth pointing out here that there is no requirement or practice from Ofcom to audit and review the merits of statutory regulation, creating a discrepancy.

5. **There is a paradox related to consumer facing schemes that lack of complaints is seen as a mark of failure.** Where the purpose of the scheme is consumer-facing and requires consumer awareness to function and succeed then the mechanism for raising awareness is critical. There is often the paradox of whether self-regulation is working as there are few consumer complaints in relation to the issue or whether a lack of complaints may link to a lack of consumer awareness of the self-regulatory regime. This can be a challenge when achieving credibility of self-regulatory regimes.

6. **Mission creep or flexible evolution?** Once self-regulatory regimes are established, there is often pressure for the scheme to go further and take in a wider scope of issues. This can lead a scheme into more complex issues that national regulators would find challenging to manage and enforce. But flexible, timely evolution should be a real benefit of self regulation – the ability to keep pace with the market. Again the question usually comes back to who pays?

7. **What role for the regulator in self regulation?** Nothing undermines industry led initiatives more than an ambivalent regulator that is unsure about whether or not to support the initiative. Too often lip service is paid to the value of self-regulation. If regulators want self-regulation to succeed they should be clear about what they want to see happen at the outset and willing to engage formally or informally in evaluation once the scheme is established. In some circumstances it may be necessary for the regulator to indicate what back-stop options it would pursue if the self regulatory initiative were deemed to have failed.

8. **Care is required to ensure co-regulation doesn't result in the worst of both worlds.** Anything requiring a regulatory backstop provisioned by law is qualitatively different. It necessitates both government and the regulator getting much more involved and can lead to confusion and uncertainty about roles, responsibilities and resources. Although there are good examples of successful co-regulatory initiatives, such as the ASA, there can be less room for pragmatism and flexibility which risks negating the potential benefits of the co-regulatory approach.

Endnotes

[i] http://www.mckinsey.com/mgi/publications/internet_matters/index.asp

[ii] http://www.connectedkingdom.co.uk/downloads/bcg-the-connected-kingdom-oct-10.pdf

[iii] http://www.connectivityscorecard.org/